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Strategies for Decreasing a Pension Plan's Unfunded Liability and Help Preserve Cash Through Real Estate

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As a trustee of a pension plan, you're becoming increasingly alarmed at the dramatic decline in the plan's funded status, despite healthy recent investment gains. You complain to company executives that substantial cash needs to be contributed to the plan to preserve its declining health, but the company maintains it simply lacks the cash to make more than its minimum annual contribution, if that.

This scenario plays out nearly every day, and although to date, there has been a lot of hand-wringing about the dire fiscal health of many corporate plans, precious few solutions have been proffered to cure the problem. Well, there's a real solution that's both tried and true and of real value to both the plan and the company: the contribution of company-owned real estate to the plan in lieu of cash to dramatically increase the plan's funded status.

Before you hyperventilate that this is a crazy idea, hold your preconceptions and let us explain. In certain instances the company may monetize the current value of its real estate by contributing it to the plan, while retaining the use of the property with little or no change in operations. This not only pulls dormant value out of the real estate, but frees up cash that would otherwise be lost due to the company's plan contribution. Here's how it works.

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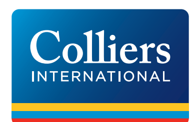

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The Hidden Value of Fully Depreciated Real Estate

Many employers hold a vast array of real estate as part of their business operations. Whether the real estate consists of office buildings, factories, retail buildings or parking lots, each asset may play an important role in the company's operations. Fully paid-for property used for company operations generally does not spin off any monetary value to the company— indeed, it is often fully depreciated on the company's books. These fully paid-for, heavily depreciated assets are a substantial, untapped source of capital which can be a solution to both boost a plan's funded status and reduce the company's obligation to fund its plan with cash.

To tap into this resource, a company contributes company-owned real estate instead of cash to meet (or exceed) its minimum required funding obligations to the company plan. The law grants companies a dollar-for-dollar credit, in lieu of cash, for the fair market value of real property transferred to its plan.

But wait, you say— the company needs its real property to conduct its business, so how can this transfer make sense? Well, to conduct a legal transfer of company-owned real estate to its plan, the law requires the company to leaseback the property from the plan at market rates. Companies typically leaseback property from their plans under triple net leases for extended terms, often with automatic renewal features. Under a triple net lease, all costs associated with the premises are borne by the tenant (the company in this case), not the landlord (the pension plan here).

Thus, the upshot of these transactions is that the company contributes already fully paid-for property to its plan in lieu of cash, the company receives contribution credit for the fair market value of the property transferred (as that value is enhanced by the rents payable under the leaseback), and the plan receives valuable, income producing real estate which is often worth far more than the company's minimum annual cash contribution (and which costs it nothing to operate), thus dramatically increasing the funded status of the plan.

This becomes clearer with an example. Assume that the company contributes its multi-building headquarters to its pension plan in lieu of cash. Further, assume that the headquarters has been significantly depreciated, and is shown on the company's books at a book value of $350 million, but currently has a fair market value of $655 million. The company's contribution of the headquarters to the plan will be at fair market value, so it will be able to take what is a $350 million asset on its books and actually get credit for its contribution at the $655 million dollar level.

But you say, there must be tax implications to such a transaction. Yes, there are tax implications. But they are generally favorable, not adverse.

> Untapped sources of capital can be a solution to boost a plan's funded status and reduce the company's obligation to fund its plan with cash.

Tax Implications from the Transaction

Given the improving values of most corporate real estate, the company is likely to realize a gain on the difference between the tax basis of the property (generally book value) and the fair market value of the property upon the date of transfer. However, the company is unlikely to pay any tax as a result of the transaction because the overall net result will be that any taxable gain realized from the transfer will be subsumed by the corresponding tax deduction for the company's in-kind contribution to the plan.

Assume the same example as provided above and further, that the company is taxed at a 21% flat rate. Based on these assumptions, if the headquarters was transferred by the company to its pension plan, the company would be credited with contributing the fair market value of $655 million to the plan, as described above. While the company would incur approximately $305 million in taxable gain,[1] that gain would be fully vitiated by an offset of $655 million in deductions for the company's contribution of its headquarters. Consequently, as a result of this transaction occurring in the year the transfer takes place, the net effect would be that that the company will reap approximately $305 million in net tax deductions ($655 million contribution value less $350 million book value), which applied at the 21% flat rate, would equal a tax savings to the company of approximately $73.5 million. So taking this transaction in a vacuum, the tax result is beneficial to the company.

Continuing Use of the Headquarters

But don't forget that the company can't very well operate without its headquarters and will need to lease it back from the plan at market rates. And the company's ongoing rent obligation will need to be added to the mix. For the purposes of our continuing example, assume that the market leaseback rental for the headquarters is $42 million a year for a total of $630 million over a hypothetical 15 year lease period. The company will be paying rent on the transferred property; however, it will receive a tax deduction for its rent payments.

To recap the foregoing example, we illustrate the company's cash outlay as follows:

Comparison of Total Cash Outlay by Company between In-kind and Cash Contribution Scenarios
(in millions)

	In-Kind Contribution		Cash Contribution	
Company's cash outlay for plan contribution	$0.00		$655.00	
--Less company's net tax savings from contribution (21% effective rate)	($73.50)		($137.55)	
Contribution net of taxes		($73.50)		$517.45
Company's aggregate rent payments (15 years annual rent @ $42 million/year)	$630.00		$0.00	
--Less company's tax savings for rent deduction (@21% flat rate)	($132.30)		$0.00	
Rent expense net of taxes		$497.70		$0.00
Total net cash outlay by the Company over 15 year period less cost of cash outlay		$424.20		$517.45
--Plus 15 years lost interest income (calculated at the rate of 1.5%/year on net $517.45 million cash outlay) ($7.76 million/year) or net $497.7 million lease payments ($7.46 million/year reduced to present value at 5% discount rate)		$457,742		116.42
Total net cash outlay		**424.65**		**633.87**

The foregoing example shows that the in-kind contribution immediately frees up substantial cash that would otherwise be spent as the employer's contribution to the plan and in the long run, costs the company substantially less cash.[2] Depending on the determination of the amount of minimum annual employer contributions, the effect of the in-kind contribution of real estate with substantial value may significantly reduce employer contributions for a number of years, while providing the plan a commercial real estate investment valued well in excess of the employer's minimum plan contribution requirements, with an extremely qualified tenant providing stable income over the life of the lease.

1 The gain is the difference between the $655 million in fair market value and $350 million in tax basis (book value) set out on the company's books. This also assumes, as is currently the case, that the corporate capital gains are taxed at ordinary income rates.

2 Not every example will produce such results. A financial analysis of properties that may qualify for in-kind contributions will be necessary to maximize cash savings. Further, the above comparison does not take into account that after the expiration of the lease term, the company will be without a company headquarters. Normally the lease will build in an evergreen clause, automatically renewing the lease term at market rates, an option for the company to purchase the headquarters at then market rates, or in some instances, the company may take the opportunity to relocate its headquarters to another site.

Addressing Liquidity Concerns

Of course, depending upon the plan's cash needs, contributing property instead of cash to the plan may cause liquidity problems. However, liquidity shortages can be mitigated by the company's contribution of a combination of cash and property. Alternately, the plan may accept rents for the leaseback that are higher than market rates. To hedge against the risk the plan might incur in selling the property upon lease maturity, companies can agree up front to repurchase the property at market value upon lease maturity, thereby providing a guaranteed buyer and enabling their plans to receive rents without the worry about such risks. To mitigate against the risk of losing access to the contributed buildings, the company can even build in an evergreen clause, automatically renewing the lease term at market rates as well as an option for the company to purchase the headquarters at then market rates

Advantages over Debt Financing

One might nevertheless wonder why, instead of going through the hassle of contributing property to the plan and then leasing it back to the company, why not merely have the company finance its minimum pension contribution with a third party loan secured by its real estate? The problem with such an option is that is nearly always more expensive.

Using our earlier example, if the company were to borrow $655 million (the fair market value of its corporate headquarters) under a loan with a 15 year term at an interest rate of 3.50% per year, its total interest cost would equal approximately $343.88 million[3] and its total payments of principal and interest would slightly exceed $998.87 million. Even if we include a tax deduction for the interest expense of 21% on $343.88 million, the employer's cash outlay would be $926.5 million,[4] substantially more than the cash outlay for rent (after taxes) of $424.20 million in the example involving the in-kind contribution provided above.[5]

More importantly, the company-owned asset transfer program has a significant advantage over that of using third-party debt for equivalent financing in that the company and its plan keep the asset in the "family." Upon the company's transfer of its headquarters to its plan, the plan gets the benefit of the headquarters ($655 million) plus $630 million in rent; whereas, if the company borrows $655 million from a third party lender under the terms previously described, the lender is paid $998.87 million, and the plan only gets $655 million (the amount borrowed). Thus, under this scenario the asset transfer is a far superior mechanism to enhance the plan's funding level while reducing the cash payable by the company to fund the plan.

ERISA Authorizes In-Kind Transfers Provided Certain Requirements are Met

The 1974 Employee Retirement Income Security Act ("ERISA") provides protections for plan beneficiaries. In those instances in which a company is dealing with its own pension plan, the transaction will be subject to ERISA requirements and, in some instances, necessitate approval by the Department of Labor ("DOL"), which administers ERISA.

The ERISA Framework

ERISA starts from the premise that the acquisition and/or lease by a pension plan of property sold or leased from its company sponsor is a "Prohibited Transaction." Section 406(a) of ERISA provides in part that:

> "Except as provided in section 1108 of this title [Section 408 of ERISA]: (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect— (A) sale or exchange, or leasing, of any property between the plan and a party in interest."

In other words, the statute generally prohibits a trustee of the plan from engaging in a transaction with the company (the "Prohibited Transactions Rule"). However, there are exceptions to the rule. A few decades ago, a U.S. Supreme Court decision confirmed that the contributions of real estate by a company to its pension plan would be generally considered a prohibited transaction, *absent an exemption*.[6] Section 408 of ERISA provides statutory exceptions to the Prohibited Transactions Rule. Provided that the statutory exceptions are met, the transaction can proceed. Even if the statutory exceptions cannot be met, there are instances in which an individual exemption from the Prohibited Transactions Rule may be obtained from the DOL.

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3 Interest is based on an amortization of interest at 3.5% per annum payable with principal in equal monthly installments.

4 The tax deduction for interest expense in this scenario would be the 21% flat tax rate multiplied by $343.88 million in interest over the life of the loan obligation for a deduction of $72.20 million. Subtracting $72.2 million from principal and interest totaling $998.7 million, leaves a cash outlay of $926.5 million.

5 This is set forth as "Rent Expense Net of Taxes" in the table above.

The Statutory Exemptions

So what is the catch? In order to avoid the Prohibited Transactions Rule, the company and the plan need to jump through a number of hoops—a relatively small price to pay for the benefits accorded them. Only certain sales of real estate by the Company to its pension plan are exempt from the Prohibited Transaction Rule. To be exempt from the rule, the transaction needs to follow Section 408(e) of ERISA,[7] which provides that the Prohibited Transaction Rule does not apply to the acquisition, sale or lease by a pension plan of real estate meeting all of the following conditions:

The property must be:

- Leased back to the company or its affiliate;
- Consist of at least two parcels which are geographically dispersed (to avoid downturns due local economic conditions peculiar to one area); and
- Each parcel and its improvements must be suitable (or adaptable without excessive cost) for more than one use, or capable of similar uses by different users.

The transaction also must:

- Be for "adequate consideration." The regulations provide that, adequate consideration is a price not less favorable to the plan than "the fair market value of the asset is as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary."[8]
- Not charge the plan a commission for the transaction.[9]

A plan trustee cannot:

- Deal with the plan assets for that trustee's own benefit or on behalf of another party whose interests are adverse to the plan or its participants[10] (e.g., the employer).Consist of at least two parcels which are geographically dispersed (to avoid downturns due local economic conditions peculiar to one area); and
- Cause the plan to invest in company real property and securities in excess of 10% of the fair market value of the plan.[11]

What can be done if a Statutory Exemption is not met?

Should the company and its pension plan be unable or unwilling to meet the statutory exemption requirements, all is not lost. The DOL has recognized that, despite the denial of the statutory exemption for failure to meet one or more of its requirements, a proposed transaction may nonetheless in certain instances provide the plan with significant benefits. Accordingly, ERISA contemplates that exemptions may be granted on an individual case-by-case basis. The DOL has adopted a detailed procedure for processing applications for individual exemptions.[12] However, the application process can be time-consuming, in many instances taking two years from start to finish. The regulations governing the application process run almost 50 pages long.

Individual case-by-case exemptions normally require the completion of a lengthy application and the submission of numerous supporting documents, including a report of an independent fiduciary representing the plan and a property appraisal by certified appraiser (e.g., an MAI appraiser certified by the Appraisal Institute). The DOL ultimately considers whether the terms of the proposed transaction are at least as favorable as those which would be available from an unrelated third party and whether the plan is receiving at least fair market value from the company. Where transactions are complex, the DOL can condition its approval on the company's adoption of additional business terms. For example, in some instances, this has taken the form of a "make whole" obligation by the company, requiring the company to contribute more funds to the plan if the financial return on its leaseback of the transferred property fails to meet a specific return target.[13]

Plan Trustee Fiduciary Obligations

Companies pursuing in-kind contribution transactions will also need to understand that, in addition to qualifying for a statutory exemption or an individual exemption, plan trustees will need to adhere to fiduciary standards of prudence and loyalty in their decision-making. The fiduciary duties of a plan trustee are embodied in Section 404 of ERISA, which requires that a plan trustee act "solely in the interest of the participants and beneficiaries." A fiduciary must "act with the skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Section 406(b) of ERISA prohibits a trustee from acting on behalf of a party or representing a party whose interests are adverse to the plan. ERISA also requires plan trustees to diversify the plan investments to minimize the risk of losses arising from geographic and investment concentration.

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[6] In the case of Commissioner v. Keystone Consolidated Industries, Inc., the U.S. Supreme Court found that the "sale or exchange" language of the statute would include instances where employers made in-kind contributions to its defined benefit plan of a number of truck terminals in order to fund its minimum obligations.
[5] 08 U.S. 152 (1993).
[7] 29 U.S.C. §1108(e).
[8] 29 U.S.C. §1002(18).
[9] 29 C.F.R. §2550.408e(a)(2). Thus, the company, as transferor, may pay commissions.
[10] 29 U.S.C. §§ 1106(b)(1) and (2).
[11] 29 U.S.C. § 1107(a).
[12] 29 C.F.R. §2570.30, et seq.
[13] Prohibited Transaction Exemption ("PTE") 96-62, 67; F.R. 44672 (July 3, 2002).

Plan Trustee Fiduciary Obligations
(continued)

Since a plan trustee may be held personally accountable for a breach of his fiduciary duties should the plan be damaged by his inappropriate action or failure to act, it is important that the company be cognizant of the trustee's role to act independently and prudently. The success of the transaction is dependent on approval of the plan trustee as much as it is on compliance with the ERISA exemptions.

To ensure that a transfer of real property to the plan being made in lieu of a cash contribution is truly in the best interests of the plan participants and beneficiaries, the plan trustees must evaluate a number of factors, including:

Will the terms and conditions of the transfer be at least as favorable to the plan as those which it could obtain in an arm's length transaction?

- Is the value received by the plan equivalent to or greater than fair market value as determined by a qualified independent appraiser using a methodology appropriate to such a determination?

Since the pension plan is accepting real property rather than cash for a minimum contribution, should it demand a premium of some kind (typically a sweetener, such as cash or contributions of liquid securities) to offset the illiquidity of the assets, or do those assets hold sufficient potential for capital gain that no such premium is necessary or appropriate?

- Is the contribution in excess of the company's minimum funding obligations?
- Will it reduce the plan's reliance on future cash contributions from the company?
- How will the impact of holding real property affect the plan's asset allocation profile?
- How will the transfer impact the pension plan's current and future cash flow needs?

What will it cost to own the real property received (e.g., property taxes, insurance, etc.)?

- Will such expenses be allocated to the company as part of its lease of the property (e.g., as triple net lease, where the tenant bears all such expenses)?
- Will professional management be required to manage the property and administer the leaseback?

What liability may result from ownership of the real property?

- Will the plan's acceptance of the contribution subject it to any material liabilities (e.g., exposure to hazardous waste, violation of land use, zoning, environmental, ADA and other health and safety rules and regulations)?
- Is the company indemnifying the plan for liabilities associated with the operation of the property and such material liabilities?

"The success of the transaction is dependent on approval of the plan trustee as much as it is on compliance with the ERISA exemptions.

Plan Trustee Fiduciary Obligations (continued)

Since a leaseback from the plan to the company is also subject to the Prohibited Transaction Rule in its own right, the exemption requirements will need to be met for that part of the transaction, as well.

- Will the terms and conditions of the lease (including rent, duration, expense allocation, etc.) be at least as favorable to the plan as would exist in an arm's length transaction with an independent party?[14]
- Will there be any form of "make whole obligation" whereby the company will during the life of the lease ensure that the plan receives a profit on its investment?
- Will the lease provide for periodic adjustment of rents (e.g., the use of an applicable consumer price index) so they are equivalent to fair market value at the time of adjustment?
- Will a qualified independent fiduciary with appropriate experience be retained:
    - To consider the fair market value of the lease as determined by a qualified independent appraiser?
    - To provide an independent fiduciary report finding the contemplated transactions to be prudent and in the interests of the beneficiaries and plan participants?
    - To negotiate, review and approve the terms of the acquisition by the plan?
    - To examine the plan's overall investment portfolio, consider its liquidity and diversification requirements, determine whether the proposed transaction will comply with the plan's investment objectives and policies and opine that the transaction is in the best interests of the plan participants and beneficiaries?
    - To monitor the lease on behalf of the plan and take such actions as it believes appropriate to safeguard the interests of the plan in the lease (e.g., in the event of an amendment to the Lease, an alteration or expansion of any buildings, the company's exercise of an option to purchase, etc.)
    - To determine whether the plan should hold or sell the property and if the latter, on what terms?

The Real Estate Transaction

From just a real estate law perspective, the sale lease-back transaction between the company and its pension plan is relatively straightforward, except as impacted by the plan trustee's fiduciary duties and compliance with ERISA and its regulations. In order to fulfill those requirements, the purchase and sale agreement should reflect the following:

- The company and plan trustees are independent parties to both the purchase and sale and the lease transactions, must not have any decision-makers in common, and must be represented by independent legal counsel.
- The terms of the purchase and sale agreement and leaseback must have been negotiated on an arm's length basis.
- No commissions will be paid directly or indirectly by the plan.
- The property held by the plan must consist of parcels located in different markets and the closing of at least two parcels meeting such requirements should occur simultaneously.
- Any additional economic inducement for acceptance of the property if the contribution would cause the plan to suffer liquidity concerns.
- The allocation of costs associated with engaging an independent fiduciary, an MAI appraiser, undertaking various studies of the property and any attorney involved in making an application with the DOL for exemptions.
- The plan trustees are obligated to conduct thorough due diligence as they would if they were acquiring real estate from an unrelated third party.
- In addition to due diligence requirements typical in any real estate transaction (title, survey, property condition, environmental, zoning, etc.), the purchase and sale will most likely be conditioned on the following matters:
- To determine whether the plan should hold or sell the property and if the latter, on what terms?
    - Representations and warranties of the company transferring the property.
    - The arm's length negotiation of a leaseback to the company as described above, with fair market value rents and commercially reasonable terms.
    - Regulatory Approvals. As described above, the process to obtain an individual exemption from the Prohibited Transaction rule can be lengthy and the transaction could be subject to modification as a condition of approval by the DOL.
    - An analysis by plan actuary of the impact to future funding levels/PBGC contributions.

[14] Given the inherent conflict of interest between the plan and the company, no affiliate or employee of the company should serve as a trustee of the plan. Normally an independent fiduciary is engaged to fulfill that role.

The Real Estate Transaction (continued)

Is the value received by the plan equivalent to or greater than fair market value as determined by a qualified independent appraiser using a methodology appropriate to such a determination?

* Whether the company is granted right of first refusal to re-acquire the property at its option during the lease term (or any extension thereof) should the plan accept offers for its purchase from third parties.
* Whether the company retains an option to purchase which it may exercise upon the expiration of the lease term (or any extension thereof).
* An allocation between the parties of liability and inclusion of indemnity provisions.
* Addressing tax issues to the plan (the potential for UBTI on lease payments and matters such as transfer taxes).
* Amendments to pension plan documents.

The foregoing list merely highlights some of the common issues that may be addressed in circumstances that are typical to a real estate transaction arising from a contribution of company owed real estate to its pension plan. Additional complexities and issues will no doubt surface and be specific to each transaction, which will require individualized attention by the parties and their respective professionals.

Conclusion

This article is intended to provide a brief outline for plan sponsors and plan trustees in considering whether to investigate a transaction involving a company's contribution of real estate to its pension plan. It is not intended to be a comprehensive guide to the subject and should not be considered as legal advice. The examples used herein are for illustrative purposes and may not necessarily apply to all situations. Consideration of specific circumstances associated with a particular transaction will necessitate a more thorough evaluation of facts and goals than raised here, and an in-depth analysis of the factual, legal and regulatory framework as applied to such a transaction. Nonetheless, in certain instances a company's use of contributions of real property to its plan may enhance the goals of both the company and the plan and provide a significant alternative in maintaining a viable plan into the future.

In-Kind Transfers of Government-Owned Realty to Cure Public Plan Deficits

It's not just corporations who can benefit from in-kind transfers of real estate to their plans— governments of any stripe, including state, county and municipal governments, can employ in-kind transfers to both preserve precious cash resources and improve their plans' funded status.

Despite a gradually improving economy, many governmental plans are seriously underfunded. Moody's Investor Services has recently reported that the unfunded liability of U.S. public pension funds is expected to rise through 2020, even under positive investment return scenarios. An increasing number of states and municipalities have become alarmed about the cash drain required to fund their ever increasing pension obligations due to years of poor investment returns, underfunding, overly generous benefits and increased longevity of the workforce. Left with the daunting task of allocating scarce resources between competing priorities of providing governmental services, infrastructure reinvestment, tax reform and pension obligations, **a number of states and municipalities are considering freeing up cash by contributing government-owned real estate to their defined benefit pension plans to satisfy the government's funding obligations.** A government's contribution of substantial amounts of real property to its pension plan could not only free up large amounts of cash for other priorities, but dramatically improve the plan's unfunded liability.

All of the reasons favoring use of in-kind real estate transfers (in lieu of cash) to fund corporate pension obligations are equally applicable to governmental real estate transfers, except as tax exempt entities, governments obviously enjoy no tax benefit from employing such strategies since they pay no taxes. Other than their tax exempt status, governments enjoy one additional benefit not shared by private employers— governments are exempt from the Prohibited Transaction Rule imposed by ERISA, and as such, governments are technically not required to comply with Section 408(e) of ERISA, which provides an exception to the Prohibited Transaction Rule for certain kinds of in-kind transfers to sponsored plans. The upshot is that governments have far more flexibility than corporations when structuring in-kind transfers of realty to their pension plans, although the very same fiduciary concerns applicable to corporate transfers apply in the government context.

In a typical in-kind transfer made by the government, the government transfers income producing real estate, such as office buildings, warehouses and other property owned and used by the government or its agencies to its pension plan. Upon such contribution, the government would be credited with contributing the fair market value of the transferred property to the plan, thereby increasing the assets of the plan by the value of the contributed property and relieving the government of having to use cash to fund employer pension contributions. Upon transfer of the property to the pension plan, the government would immediately lease the property back from the plan. The terms of the leaseback would be negotiated between the government transferring the property and the plan, and the very same considerations governing negotiation of such terms in the corporate context would apply in the governmental context. To that end, the plan would likely insist on payment to the plan of market rents, assumption by the government of all costs of maintaining the property (as well as all potential liabilities associated with the property), an obligation by the government to repurchase the property in the event of lease termination and perhaps an obligation by the government to pay the plan some cash in addition to the transferred property to address any liquidity concerns posed by the transfer of property instead of cash to the plan.

While no panacea, a government's contribution of real property to its pension system may enable the government to free up precious cash for other, more pressing purposes while nevertheless reducing the pension system's unfunded liability. For this reason, real property transfers may make sense to both the government and its pension system and should be seriously considered.

1 As reported by Meaghan Kilroy in Pension & Investments (June 20, 2017) http://www.pionline.com/article/20170620/ONLINE/170629984/

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